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DIRECTOR LIABILITY

Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflicts of Interest

BY GARDNER DAVIS AND RICHARD GUYER

Venture capital firms and their director designees on portfolio company boards can find themselves stuck between their fiduciary duty to common shareholders and the terms of preferred investment documents. Before any other contracts or commitments, directors are obligated to put the interests of common shareholders first -- acting otherwise puts those directors at risk of breaching that duty.

The routine practice of venture capital funds appointing directors to the boards of corporations in their portfolio is generally advantageous to the company, its stockholders and other investors. But while an early-stage startup benefits from the sophistication, experience and network of the seasoned directors designated by venture funds, structural conflicts of interest also create risk of liability under Delaware corporate law.

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Although the venture fund-nominated director has a natural affinity for the fund's economic interests, the duty owed is exclusively to the common stockholders, not to holders of preferred stock, warrants or convertible debt. That representative can then be put in the difficult situation of putting the common stockholders' interests – usually the founders, angel investors and employees – ahead of the venture fund.

The director's legal duty is to the common stockholder in the long term, requiring a course that ignores fixed investment horizons. The board has no fiduciary duty to maximize current market value or facilitate the venture fund's exit.

Conflict of Interest and "Entirely Fair"

The venture fund risks being drawn into stockholder litigation under the theory that the fund "aided and abetted" the breach of fiduciary duty by its designee director or under the theory that the venture fund controlled the portfolio company. This litigation is more difficult to defend than garden-variety claims against corporate directors because the business judgment rule, a judicial presumption which protects directors from liability for good faith mistakes, does not apply in the

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conflict-of-interest context. Corporations also can't indemnify directors against personal liability for breach of the duty of loyalty under Delaware law.

In stockholder litigation alleging conflicts of interest by directors and controlling stockholders for favoring the interests of preferred stockholders over the common stockholders, the court applies the most onerous standard of review under Delaware law: entire fairness. Defendant directors and venture funds must establish that the transaction was the product of both fair dealing and fair price. Not even an honest belief that the transaction was entirely fair is sufficient to establish entire fairness. The transaction itself must be objectively fair, independent of the board's beliefs.

The Delaware Chancery Court has recently addressed several instances of the risk faced by venture capital firms and their director designees on portfolio company boards from shareholders saying they placed the preferred stockholder interests ahead of the common stockholders in conflict-of-interest situations. In each case, the Delaware Chancery Court applied the stringent entire fairness standard of review and denied the defendants' motion to dismiss the suit, thereby exposing the defendants to the expensive and time consuming burden of a trial on the merits unless they settled the case.

Recent Delaware Case Law

Frederick Hsu

In *Frederick Hsu Living Trust v. ODN Holding Corp.*, 2017 BL 133850 (Del. Ch. April 24, 2017), the Delaware Chancery Court declined to dismiss a lawsuit that claimed a venture firm and its representatives on the portfolio company board sought to maximize the venture firm's preferred stock redemption right, instead of the value of the company for the long-term benefit of common stockholders.

The venture fund invested $150 million in Oversee.net by purchasing preferred stock with a mandatory redemption right beginning five years after the investment. The fund acquired mathematical control over the company's voting power through subsequent purchases of stock and thereby became a ''controlling stockholder'' for purposes of Delaware law and appointed three representatives to the company's eight-member board of directors.

Time passed, and Oversee.net sold three of its four business lines in their entirety, also divesting the principal economic driver of its remaining segment. The sales slashed the company's cash-generating capacity – before the divestitures, the company generated annual revenue of $141 million. Afterward, revenue dropped to $11 million, a 92 percent decline.

The complaint alleged that the fund-appointed directors breached their fiduciary duties by abandoning the company's growth strategy which benefited all stockholders in favor of selling off whole business lines and hoarding cash to fund the redemption of the preferred stock, thereby providing the biggest-possible nonratable economic benefit for the venture fund.

The fact that a corporation is bound by its valid contractual obligations doesn't absolve directors of their fiduciary duties to common stockholders. Even with ironclad contractual obligations, there remains room for fiduciary discretion because of the doctrine of efficient breach, where a party to a contract may decide that its most advantageous course is to breach and pay damages, according to the Delaware Court of Chancery's Vice Chancellor Laster. As with any decision, the board of directors may choose to breach if the benefits exceed the costs. A corollary to this principal, according to Laster, is that directors who choose to comply with a contract when it could be value-maximizing to breach could be subject, in theory, to a claim for breach of duty.

Many investors treat the mandatory redemption date of preferred stock as the equivalent of a loan maturity date and believe the corporation is unconditionally obligated to repurchase the preferred shares. They are mistaken. Preferred stock provides no guaranteed right of payment and its redemption obligation is not treated as debt or a current liability. Section 160(a)(1) of the Delaware General Corporation Law and common law limit the company to only making redemptions out of ''funds legally available'' and restrict redemptions when the corporation would be rendered insolvent. A corporation may have funds on hand to operate and grow the business which do not technically qualify as ''legally available'' for the redemption.

Because the fiduciary principle doesn't protect special preferences or rights, that standard of conduct requires the decision makers to focus on promoting the value of the undifferentiated equity in the aggregate. In order to raise legally available funds to pay for the redemption, ''a board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights,'' according to Laster.

Calesa Associates

In *Calesa Associates, L.P. v. American Capital Ltd.*, 2016 BL 58147 (Del. Ch. Feb. 29, 2016), the Delaware Chancery Court declined to dismiss a lawsuit by the common stockholders of Halt Medical Inc. against a venture fund and its board representatives arising from a recapitalization transaction which increased the venture fund's ownership from 26 percent to 66 percent. The venture fund also provided a loan secured by a blanket lien on the company's assets.

The complaint alleged that the board received, approved and signed the transaction documents on the same day, and says that because of this tight time frame, the board approved the transaction with little or no analysis as to its fairness to the common stockholders. Key mechanisms to secure fairness were absent: There was no independent valuation of the transactions or the benefits the company was to receive in exchange for the financing, no fairness opinion or assistance of a financial advisor, no special committee of independent directors to review the transaction, no opportunity to explore financing from other sources under more advantageous terms, nor any board meeting to vote on the transaction documents.

The plaintiffs also alleged the venture fund acted in bad faith to mislead the other stockholders about the purpose of the recapitalization. According to the complaint, the fund represented that the purpose of the deal was to allow the company to be sold to a third party. The transaction documents provided that if the company was not sold within one year of the transaction, the subordinated debt owned by minority investors would be converted to equity and the preferred stock owned by minority investors would be cancelled. The plaintiffs alleged that the venture fund's true motive emerged only after the transaction: to starve the company, ensuring the dilution of the minority stockholder interests and the cancellation of their preferred shares, all in order to ''squeeze'' the minority investors out of the company. The fund had no intention to sell the company, seeking instead to seize the value of the company for itself, they said.

The facts, when viewed, as required, in the light most favorable to plaintiffs, present a very problematic picture from a basic corporate governance perspective. The venture fund was alleged to control the company because it exercised control over the ''corporate machinery'' and therefore owed a fiduciary duty to the other stockholders.

Trados

In some cases, what looks at first like preferential treatment for preferred stockholders is found to be fair to common shareholders. The Delaware Chancery Court denied a motion to dismiss a shareholder lawsuit arising from the sale of a venture-backed firm where management received almost $8 million and the preferred stockholders received almost $60 million pursuant to their liquidation preference but the common stockholders received nothing in *In re Trados Incorporated Shareholder Litigation*, 2009 BL 162187 (Del. Ch. July 24, 2009).

The plaintiffs alleged that there was no need to sell Trados at the time because the company was well-financed, profitable and beating revenue projections, but instead the merger took place to benefit the preferred stockholders who wanted to exit their investment.

The Delaware court's Vice Chancellor Chandler denied the defendants' motion to dismiss, holding that the board's duty is to prefer the interests of the common stock.

At trial, *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013), Laster ruled in favor of the directors and the venture firm because under Trados' business plan, the common stock had no value before the merger, making it fair for its holders to receive in the merger the substantial equivalent of what they had before. However, the opinion makes clear that ''the standard of conduct for directors requires that they strive in good faith to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants.''

Laster found that, even despite ''often problematic testimony,'' the transaction was fair, despite a laundry list of flaws: ''The defendant directors did not adopt any protective provisions, failed to consider the common stockholders and sought to exit without recognition of the conflicts of interest presented by the merger.''

Reducing Risk to Directors

The result in all three of the forgoing cases could have been different if the venture funds and their representatives on the board had taken action to address the conflict of interest and to limit their risk of liability. Ideally, a board should contain several truly independent directors who are not beholden to the venture funds or management. Those directors can act as a special committee to bargain on behalf of the company and common stockholders in conflict situations. Boards can engage an outside valuation expert to advise on the fairness of future financing rounds, including prevailing market terms. If that is not practical or affordable, the board should clearly document the basis for the pricing of any subsequent financing round and provide an opportunity for management and the founders to provide input. Common stockholders should be allowed to participate equally in any subsequent financing rounds. Finally, the board may seek approval from a majority of the disinterested common stockholders after adequate disclosure.

In cases where the venture fund is not part of a control group, the fund can accept an observer position which entitles its designee to participate in all board deliberations without an actual vote, instead of a fully privileged board seat. A board observer does not owe any fiduciary duty, insulating the fund from any potential liability; the venture fund may rely on the contractual provisions in its investment documents for protection.

The venture fund can also organize the company as a Delaware limited liability company rather than a corporation to mitigate risk. The Delaware LLC statute, unlike the corporate statute, expressly authorizes the members of an LLC to modify by contract the director's fiduciary duty to more closely align with the real world expectations of venture capital investors.